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No. 1143

In the Supreme Court of the United States

OCTOBER TERM, 1969

MIDWESTERN UNITED LIFE INSURANCE COMPANY,

Petitioner,

vs.

TORA C. BRENNAN,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Petitioner Midwestern United Life Insurance Company, (hereinafter referred to as MULIC), defendant-appellant in the court below, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Seventh Circuit in this case.

Opinions Below

The opinion of the United States District Court for the Northern District of Indiana, Fort Wayne Division, denying MULIC's motion to dismiss the complaint is reported at 259 F.Supp. 673 (1966) (App. A., 1-24[1]). The District Court's opinion on the merits is reported at 286 F.Supp. 702 (1968) (App. B, 25-86). The opinion of the United States Court of Appeals for the Seventh Circuit is reported at 417 F.2d 147 (1969) (App. C, 87-115).

Jurisdiction

The decision of the Court of Appeals was rendered on September 29, 1969. A petition for rehearing *en banc* was filed on October 13, 1969 and denied on November 5, 1969.

Jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

Questions Presented

1. Does Section 10(b) of the Securities Exchange Act of 1934 or Rule 10b-5 of the Securities and Exchange Commission impose a duty upon corporations to police the conduct of brokers dealing in their securities and to report irregularities to the SEC or a state regulatory commission when the corporation has no connection or relationship with the broker and is not trading in its own securities? Under Section 10(b) or Rule 10b-5 are corporations subject to civil liability to persons injured by the misconduct of an independent broker if they fail to report to the regulatory agencies under the circumstances described above?

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[1] App. ....." refers to the separate appendix, submitted with this petition, containing the three prior opinions in this case. "A. ....." refers to the two volume appendix filed in the Court of Appeals. "R. ....." refers to the record on appeal in the Court of Appeals.

2. There is confusion and conflict among the Circuits as to the proper standards for reviewing inferences drawn by a trial judge under Rule 52(a), and with respect to the burden of proof and the propriety of compounding inferences in the expanding area of civil liability for securities and business fraud. These conflicts should be resolved by this Court. Here the District Court's findings of "knowledge" and "proximate cause" were admittedly reached by pyramiding inferences and shifting the burden of proof to defendant. Did the Court of Appeals err in approving those rulings and holding that on review inferences of the trial court must be accepted if they "*could*" have been reached by logical deduction?

Constitutional and Statutory Provisions Involved.

Section 10(b) of the Securities Exchange Act of 1934 provides:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> "(b) to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule 10b-5 of the Securities Exchange Commission (17 C.F.R. § 240.10b-5) (1968) provides:

> "It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of a national securities exchange,

"(a) to employ any device, scheme or artifice to defraud,

"(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which they were made, not misleading, or

"(c) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

Rule 52(a) of the Federal Rules of Civil Procedure provides in pertinent part:

"(a) *Effect.* In all actions tried upon the facts without a jury or with an advisory jury, the court shall find the facts specially and state separately its conclusions of law thereon, and judgment shall be entered pursuant to Rule 58; . . . Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses. . . ."

STATEMENT OF THE CASE.

Plaintiff Tora C. Brennan on behalf of herself and all others similarly situated filed suit on November 19, 1965, against defendant Midwestern United Life Insurance Company, an Indiana corporation whose shares are publicly traded over the counter, alleging that MULIC was liable to plaintiff for losses suffered as a result of her purchase of the capital stock of MULIC from Dobich Securities Corporation, an Indiana licensed intrastate securities dealer. (A. 1, 5, 62, 65.)

Michael Dobich, the principal of Dobich Securities Corporation, was killed on July 10, 1965. Plaintiff and several hundred other persons who had purchased nearly $3,000,000 worth of the petitioner's stock from Dobich had not received delivery of their shares. It was soon revealed that Dobich Securities Corporation had not owned the shares it purported to sell, had not made covering purchases, and was utterly insolvent. (A. 65, 292, 294.)

Unbeknown to petitioner, Dobich was operating a "bucket shop." His technique was to sell large quantities of stock of various companies, particularly insurance companies, without making the covering purchases necessary to deliver the stock sold. After developing a short position Dobich would endeavor to depress the value of the stock and then make purchases of the depressed stock so as to cover his short sales at lower prices. Meanwhile he was using his customers' money for private speculation. Dobich was an extraordinarily accomplished confidence man. For many years he was able to deceive thousands of customers as well as the Indiana Securities Commissioner and many of his own salesmen, who themselves purchased stock from Dobich. (See A. 165-226, 320-22, 377.)

In contrast to his skill as a confidence man, Dobich's speculations as an investor were disastrous. As his private losses increased, diversion of customers' money mounted. While Dobich maintained the appearance of prosperity, it was revealed upon his death that he and his corporation had been hopelessly insolvent since long before the spring of 1964 when he first began dealing in the petitioner's stock. (A. 349, 351-52.)

Petitioner first heard of Dobich in May of 1964 when a MULIC shareholder complained to petitioner's president that a Dobich salesman had attempted to sell him MULIC stock on the basis of a false rumor that petitioner was planning to acquire another insurance company. The sale price offered by the Dobich salesman was five points above the quoted over-the-counter market. MULIC verified the complaint and communicated it to the Indiana Securities Commissioner. Other than calling in Mr. Dobich and "warning him" about unreasonable spreads and false rumors, the Indiana Securities Commissioner did nothing. (A. 185-90, 563.)

Petitioner next heard about Dobich in August of 1964 when it received a letter from a customer of Dobich's who reported that he had purchased petitioner's stock from Dobich on May 27 and had not yet received the certificate. By September 28, 1964, petitioner had received three more complaints of slow delivery and on that date petitioner's general counsel wrote a letter to Dobich demanding that he speed up his delivery of its shares. (A. 82, 85, 87, 89-91, 511.) Unbeknown to plaintiff, the Indiana Securities Commissioner had received at least 17 complaints about Dobich by September 28. (A. 161-207, 304-05.)

On October 6, petitioner received another late delivery complaint. Petitioner demanded that Dobich con-

tact both the complaining customer and petitioner about the transaction. (A. 92-94.) In response Dobich met with petitioner's president and general counsel on October 12. He claimed that he was selling a great deal of petitioner's stock, that the stock that he owned was pledged for collateral, and that he was having difficulty obtaining release of the shares needed for transfer and getting delivery from other brokers. Dobich indicated that it would take him two weeks to become current. Petitioner's officers demanded that he do so. (A. 473-78, 575-81.) The following day petitioner's general counsel wrote to Dobich stating (A. 95):

> "... If we receive information after two weeks from now that you are not making transfers to purchasers of MULIC stock within the normal time required of a broker to effect such transfers, we will have to refer future inquiries to the Indiana Securities Commissioner for a suitable investigation."

Within the next few days petitioner received three more complaints about slow delivery. Complaints to petitioner then ceased for some six weeks until November 23, 1964, when one additional complaint was received. (A. 96-99, 587, 667, 672-73.)

As was subsequently revealed, however, Dobich had done nothing in this period to clear up his problems and, to the contrary, had added to his short position in MULIC by some 3,700 shares having a value of over $300,000.00. (A. 331-32; R. 581-618, 1621-2179, *passim*.)

On November 30, 1964, petitioner's general counsel wrote to Dobich reporting petitioner's advice to the latest complaining purchaser (A. 105):

> "... We are suggesting to [the purchaser] that, in the event he does not receive his stock immediately

or does not receive a satisfactory explanation for the delay, he turn the matter over to his personal attorney and/or contact the Indiana Securities Commissioner.

"I hope it will not be necessary for him to take this action."

A copy of this letter was sent to the customer, along with a letter suggesting that the customer contact the Commissioner if prompt delivery were not received, and providing the Commissioner's name and address. (A. 104-05.)

Substantially identical treatment was accorded a complaint received on November 30, 1964. At the time that these letters were written, all customers who had previously complained to petitioner about slow delivery from Dobich had received their stock. (A. 80, 107.)

The Indiana Securities Commissioner received an additional 22 separate complaints about Dobich after November 30, 1964, including several which involved multiple purchases. Indeed, two of these complaints to the Commissioner were received from salesmen for Dobich who were finding it impossible to obtain delivery for their own customers. One listed 10 separate sales and another 12 separate sales of securities which had not yet been delivered. (A. 161-226, 310-17, 323.)

By the time of Dobich's death in July 1965 the Commissioner had received complaints of slow delivery by Dobich involving purchases by at least 69 different purchasers.

Despite this steady stream of complaints the Indiana Securities Commissioner failed to take any action other

than to inform Dobich of some of the complaints and request that he make delivery. (A. 718-49, 877-90.)

The only motive which the court could attribute to MULIC to explain why it could possibly want to aid and abet Dobich was that during some of the period in question petitioner was engaged in negotiations for mergers with other corporations and may have thought that Dobich's conduct would help the price of its shares to remain high. (App. B, 54-55, 72-73; App. C, 98-99.) It is undisputed that petitioner did not participate in any way in any of Dobich's securities transactions. Petitioner had no contact or communication, direct or indirect, with the persons in plaintiff's class, and received none of the money which Dobich obtained from them for the purchase of petitioner's stock. All of the sales were in the secondary market and involved only shares that were already issued and outstanding.

Nevertheless, petitioner was held liable to all persons who purchased its shares from Dobich after December 1, 1964. This liability is predicated on the District Court's theory that (a) Petitioner must have known of the fraudulent nature of Dobich's transactions by November 30, 1964; (b) MULIC's letters of November 30 constituted a "withdrawal" of its earlier threat to report Dobich directly to the Commissioner and a "signal" to Dobich that MULIC would not expose him, which thus aided, abetted or encouraged him; (c) petitioner had a legal duty to report Dobich to the Commissioner which it thus violated; (d) the failure to report was causally linked to the losses suffered by the plaintiff class because if such a report had been made the Indiana Commissioner would have put

Dobich out of business; and (e) the "signal" was causally linked to plaintiff's losses because without it Dobich would have voluntarily discontinued his fraud.[2]

It is the holding that MULIC had a legal duty to report what it purportedly knew of the activities of an independent securities broker to the Indiana Securities Commissioner that constitutes a significant and dangerous extension of the federal securities law worthy of review in this Court.

In addition, the conflict among the lower courts on basic questions of burden of proof and the handling of inferences in the ever expanding area of securities law and business fraud should be examined and resolved.

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[2] The undisputed evidence so clearly refutes this aspect of the causal connection issue that the majority opinion of the Court of Appeals drops this finding, thus leaving the causal relationship dependent on the proposition that, if MULIC had reported to the Commissioner on December 1, 1964, the nine complaints it had received, he would have investigated and discovered Dobich's insolvency, even in the face of the fact that the Commissioner had received 69 such complaints from Dobich's customers and salesmen without any investigation. (App. C, 100-01.)

REASONS FOR GRANTING THE WRIT

I.

THE HOLDING OF THE COURT OF APPEALS THAT A CORPORATION'S FAILURE TO REPORT STOCK PURCHASE AND SALES ACTIVITIES OF AN INDEPENDENT SECURITIES BROKER TO REGULATORY AGENCIES SUBJECTS IT TO LIABILITY TO ANYONE INJURED BY THE BROKERS MISCONDUCT IS A DANGEROUS AND UNWARRANTED EXTENSION OF SECTION 10(b) AND RULE 10b-5.

This case presents a novel and far reaching question under the Securities Exchange Act. The two to one majority opinion of the Court of Appeals holds, for the first time in any court, that a corporation has an affirmative duty to report to regulatory agencies the activities of an outsider dealing in its securities if it knows or should know that those activities may constitute a violation of the Securities Exchange Act. For breach of that "duty", the court imposes civil liability on the corporation to anyone injured by the broker's misconduct, even though his activities are totally independent of and beyond the direction or control of the corporation and utterly unconnected with any purchase or sale of securities by the corporation.[3]

The holding of the Court of Appeals not only carries corporate liability to investors beyond any reasonable read-

[3] The decision of the District Court affirmed by the Court of Appeals has been described as holding: "that an issuer of stock who has knowledge that its stock is involved in a transaction of such nature that section 10b and Rule 10b-5 are violated, has a duty to disclose this violation upon pain of civil liability." Note, 35 U.Mo. K.C.L. Rev. 320, 332 (1967) The note writer concluded that such a holding was clearly improper. See also A. Bromberg, *Securities Laws: Fraud—SEC Rule 10b-5*, Sec. 5.2, p. 95, n. 20 (1969).

Moreover, as discussed in Part II of this petition and in the dissenting opinion, the "knowledge" finding is at best the result

ing of Section 10(b) or Rule 10b-5, (the provisions relied on), and far beyond any previous decision, but subverts the spirit and intent of the Securities Exchange Act. As a practical matter the result in this case is to require the cautious investor to insure losses resulting from the negligence of incautious investors lured by the siren-song of a tipster-confidence man.

There is no doubt that Dobich, the broker-dealer, made many sales of MULIC stock in violation of Section 10(b) of the Act. It is undisputed, however, that petitioner was not a party to those transactions, received no portion of the proceeds and had no contact or communication, direct or indirect, with the plaintiff or any member of her class. There is no evidence that petitioner was informed of Dobich's sale to plaintiff or any member of the class except those few who complained and were advised to complain to the Commission.

The "knowledge" of Dobich's overall conduct which the Court attributed to MULIC was not in any sense "inside information." Indeed, it came to MULIC from the public in the form of inquiries about slow delivery, a complaint which was shared but never voiced by plaintiff. As the dissenting judge stated, "The only failing of which Midwestern is accused is failing to report each complaint of late delivery to the Commissioner. That it admittedly didn't do. Neither did the plaintiff. . . ." (App. C, 115.)

The Court of Appeals characterized the petitioner's failure to report Dobich as a form of "aiding and abetting

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of pyramiding strained inferences. Thus, the overall effect of the holding is to compel corporations to actively police the conduct of everyone dealing in the secondary market for their securities or run the risk of civil liability for an outsider's misconduct which some court finds, with hindsight, was or should have been known to the corporation.

cognizable under Section 10(b) and Rule 10b-5." (App. C, 101.) While the court also found what was styled "affirmative" conduct on the part of the petitioner in such aiding and abetting, the "affirmative" conduct referred to consisted *solely* of MULIC's letter of November 30, 1964, which purportedly "signaled" Dobich that petitioner did not intend to report the slow delivery complaints directly to the regulatory agencies. (App. C, 97-99.) It is obvious that unless there was a duty to report Dobich in the first instance, there can be no duty to carry out a threat to report.[4] Once again, the dissenting judge was clearly right in stating that "The only legal duty to make such a report of which we are told is a completely fictitious one supposedly created by Midwestern's own threat to do so. . . ." (App. C, 115.)

Thus, the issue squarely presented is whether Section 10(b) can be read to impose liability upon an issuer for failure to report irregular transactions in its shares. In phrasing liability in terms of a form of aiding and abetting *"cognizable under Section 10(b) and Rule 10b-5,"* the Court of Appeals recognizes that there is no such duty to report under general tort law.[5] Section 10(b) is invoked by implication, but on what inference? Clearly no such duty is imposed by the express terms of the Act or by any SEC

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[4] The Court of Appeals suggests that it is not deciding whether the failure to report "in itself" violated Rule 10b-5, but in finding a duty to report under Rule 10b-5 that is precisely what the Court has done.

[5] There is no general duty to prevent or to report the tortious act of another. 86 C.J.S. Torts § 33, p. 948. Nor is there a duty to report or prevent a crime. *Bratton* v. *United States*, 73 F.2d 795 (10th Cir. 1934); *Neal* v. *United States*, 102 F.2d 643 (8th Cir. 1939). See generally, Note 35 U.Mo. K.C.L. Rev. 322 (1967), discussing these doctrines at length in the context of this case. Failure to report a crime is not criminal "aiding and abetting." *Nye & Nissen* v. *United States*, 330 U.S. 613, 619 (1949); *Johnson* v. *United States*, 195 F.2d 673, 675-76 (8th Cir. 1952).

rule or regulation; neither has any court heretofore imposed such a duty under federal law. If there is such an obligation, it can only be founded upon an extension of the "spirit" or "intent" of the Securities Exchange Act.

We submit that an extension which goes so far beyond the language of the Act is beyond the proper powers of the judiciary and that, in any event, the extension proposed here does *not* follow the spirit or intent of the Securities Exchange Act. Rather, the split decision of the Court of Appeals if followed in other cases will result, as here, in gross inequities to innocent investors, the very persons whom the Act is intended to protect. A judgment against an issuer in favor of purchasers of its shares who because of broker fraud did not receive delivery of those shares is necessarily borne by the stockholders of the corporation. The rule adopted by the Court of Appeals—with the extent of liability turning on the volume of the issuer's shares purchased from an unscrupulous outsider—involves the risk of liability very large in proportion to the size of the issuer. Indeed the liability in this case could exceed 30% of petitioner's net worth. (A. 294, 328.) The result is to shift the loss of a group of negligent investors to those who were prudent and cautious.[6]

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[6] During the period while 419 persons in plaintiff's class, as defined in her complaint, were, unbeknown to plaintiff, purchasing stock from a fraudulent broker-dealer on the basis of a "tipster" sales approach, and while those persons were waiting month after month for delivery without complaint or investigation, other shareholders were purchasing and receiving over 190,000 shares of petitioner's stock from reputable brokers and dealers. (A. 229, 294.) Still others, who purchased from the fraudulent broker-dealer, made complaints to protect themselves and promptly received their stock. Another large group, of course, purchased their MULIC shares before Dobich ever started his activities. It is these persons who protected themselves by diligence in complaining of slow deliveries or by dealing with reputable brokers in the first instance who will ultimately pay the losses of those who failed to protect their own interests if this decision stands.

We submit that Judge Waterman was correct in asserting that the purpose of Rule 10b-5 is "to qualify, as between insiders and outsiders, the doctrine of *caveat emptor*—not to establish a scheme of investors' insurance." *List* v. *Fashion Park, Inc.*, 340 F.2d 457, 463, (2d Cir. 1965), *cert. denied sub nom. List* v. *Lerner*, 381 U.S. 811. See also Ruder, "*Texas Gulf Sulphur*—The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases" 63 Nw. U.L.R. 423, 443-44 (1969); Note, 82 Harv. L. R. 938, 949 (1969).

The sweeping extension of corporate liability for acts of outsiders which this case accomplishes has not passed unnoticed. The Assistant General Counsel of the SEC has declared that if the holding that MULIC's "silence" is actionable is followed by other courts, "substantial new obligations would be imposed upon the corporation in a variety of areas."[7]

Similarly, Professor Alan R. Bromberg calls the district court's decision "the farthest extension into this [non-disclosure liability] area." A. Bromberg *Securities Law: Fraud—SEC Rule 10b-5* Sec. 7.4(2) p. 166 n. 98 (1969).

The SEC itself has evidently refrained from asserting that non-disclosure is actionable under Rule 10b-5 in cases where the company is not trading in its own securities, even where internal corporate information is involved, much less the alleged knowledge of misconduct of an outsider which is involved here.[8]

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[7] Feuerstein, "The Corporation's Obligations When It Is Not Trading In Its Stock," *Obligations to Stockholders in Stockholder Litigation* (Ill. Inst. Cont. Legal ed. 1969), p. 28. The most significant of these, of course, will be the almost impossible task of screening and policing the conduct of the thousands of independent securities brokers around the country.

[8] Feuerstein, loc. cit., p. 20.

The decision in this case represents an unprecedented, unwarranted and unjust extension of the law which has the effect of penalizing innocent investors and thus contravenes the very purpose of securities regulation. Any such expansion should be left to Congress or should at least be predicated upon a rationale or principles set forth by this Court.

II.

THE RULES APPLIED BY LOWER COURTS IN ANALYZING AND REVIEWING IMPORTANT EVIDENTIARY QUESTIONS AND STANDARDS OF PROOF IN CASES INVOLVING THE EXPANDING CONCEPT OF CIVIL LIABILITY FOR SECURITIES ACT VIOLATIONS AND BUSINESS FRAUD ARE IN CONFLICT AND SHOULD BE CLARIFIED.

The opinions of the District Court and the majority of the Court of Appeals provide classic examples of the confusion which is prevalent among the lower courts in cases involving liability for aiding or conspiring to commit fraud.

Preoccupied with the novel questions of substantive law presented by the expansion of civil liability for business and financial misconduct, the courts have neglected to establish and maintain clear standards with respect to basic questions involving the burden of proof, the proper role of inferences and circumstantial evidence, and the standards of appellate review. Especially where a plaintiff attempts to impose liability upon a peripheral defendant on a conspiracy or aider and abetter theory in a complex business or securities fraud situation, the treatment of inference, circumstance, probability and speculation assumes major significance at both the trial and appellate level. The lower courts are in confusion and conflict on these issues and the time has come for this Court to provide guidance.

A.

Misplacing the Burden of Proof

If civil liability for the fraudulent conduct of others is to be imposed upon defendants whose offense consists of silence and inaction, and indeed whenever aiding and abetting or conspiracy is charged against persons on the fringe of a business fraud, one of the few protections which the defendant has is the requirement that the plaintiff bear the burden of proving the essential elements of his case by a preponderance of the evidence. Where a fraud has occurred it is inevitable that those affected will look to any solvent person who had the slightest connection with the affair as a potential source of recovery. Only if the requirement that the plaintiff prove the essential elements of his case is zealously protected can the defendant hope to avoid a decision based upon sympathy, suspicion or conjecture. Nevertheless it is in this expanding field of peripheral liability—where a clear concept of the burden of proof is most essential—that it has been most frequently ignored or obscured. The danger in loose judicial practices in the area of conspiracy law was pointed out by Mr. Justice Jackson in *Krulewitch* v. *United States,* 336 U.S. 440, 445, 452 (1949) (concurring), where he warned against lowering the requirements of proof to permit findings of guilt. See Goldstein, "The *Krulewitch* Warning: Guilt by Association," 54 Geo. L.J. 133 (1965). The opinions of both the District Court and the Court of Appeals provide classic examples of the evils which Justice Jackson perceived.

The District Court correctly held that an essential element of plaintiff's case is the existence of some proximate relationship between defendant's alleged inaction and plaintiff's injury. Nevertheless, supported only by a *dissenting*

opinion in *Baird* v. *Franklin*, 141 F.2d 238 (2nd Cir. 1944) *cert. den.* 323 U.S. 737, the district judge held that once the plaintiff adduced *some* evidence from which proximate cause could be inferred, *the burden was on defendant to disprove proximate cause by a preponderance of the evidence.* (App. B, 77-78.) This extraordinary ruling, which is contrary to unbroken authority that the plaintiff bears the burden of proof of proximate cause,[9] was raised on appeal but virtually ignored in the majority opinion.

B.

The Decision of the Court Below is Founded on a Novel Theory of Drawing and Compounding Inferences

Charges of aiding and abetting or conspiring to commit a complex business fraud frequently must be proved by inference and circumstance rather than direct evidence. Thus a problem which is encountered with peculiar frequency in peripheral liability cases is defining the evidentiary foundation required to support an inference. Another frequent question is when, if ever, it is proper to compound inferences.

This case involves clear examples of both the error of drawing inferences from speculation rather than evidence and the error of compounding or pyramiding inferences. *United States* v. *Ross*, 92 U.S. 281, 283-84 (1875). On these issues we refer the Court to the vigorous dissenting opin-

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[9] That the burden of proof of proximate cause in tort cases is on the plaintiff is hornbook law. Prosser, Torts p. 245 (3rd ed. 1964). The case which is perhaps closest on its facts is indeed the *Baird* case in which the majority correctly stated that the "[Plaintiffs] had the burden of showing that the breach of duty was the cause of their loss." (141 F.2d at 239.) Thus a conflict now exists between the Second and Seventh Circuits on this question.

ion of Judge Morgan which fully exposes the District Court's unsupported findings, particularly with respect to "knowledge" and "proximate cause". (App. C, pp. 103-115.) In view of the enormous growth of litigation in this area there is urgent need for this Court to set forth the circumstances in which a trial court may properly draw and compound inferences in cases of this type.

C.

The Decisions Are In Conflict as to the Proper Application of Rule 52(a) In Reviewing Inferences Drawn By The Trial Judge From Undisputed Facts

Most of the ultimate findings in this case were based on inferences drawn by the trial court from basic facts which were either undisputed or determined and stated by the trial court.[10] There is great confusion among the Circuits with respect to their role in reviewing inferences drawn by a trial judge. For many years there was a split among the circuits on whether Rule 52(a) applied to inferences drawn by a trial judge at all, and if so, the weight to be afforded such inferences. Compare, for example, *National Latex Products Co.* v. *Sun Rubber Co.*, 274 F.2d 224, 247 (6th Cir. 1960), *cert. denied* 362 U.S. 989; *E. H. Sheldon & Co.* v. *Commissioner*, 214 F.2d 655, 658-59 (6th Cir. 1954); *Stubbs* v. *Fulton National Bank of Atlanta*, 146 F.2d 558, 560 (5th Cir. 1945), *cert. denied* 325 U.S. 864; *Sears, Roebuck & Co.* v. *Johnson*, 219 F.2d 590, 591 (3rd Cir. 1955) (all holding, in effect, that the Court of Appeals is free to draw its own inferences from established facts), with *Orvis* v. *Higgins*, 180 F.2d 537, 539 (2nd Cir. 1950), *cert. denied* 340 U.S. 810; *American*

[10] The Court of Appeals states that a determination of credibility necessarily played some part in the trial court's findings. Petitioner, however, does not challenge any of the trial court's findings on credibility or disputed evidence.

Tobacco Co. v. *The Katingo Hadjipatera,* 194 F.2d 449, 451 (2nd Cir. 1951), *cert. denied* 343 U.S. 978 (1952); *Kuhn* v. *Princess Lida of Thurn and Taxis,* 119 F.2d 704, 705-06 (3rd Cir. 1941); 5 Moore's Federal Practice ¶52.04 (1969 ed.) (all stating that while Rule 52(a) is applicable the standards of review are more liberal where for one reason or another questions of credibility are not involved), and *Hill* v. *Gregory,* 241 F.2d 612, 614 (7th Cir. 1957), *cert. denied* 354 U.S. 938; *McDermott* v. *John Baumgarth Company,* 286 F.2d 864, 868 (7th Cir. 1961); *Randall Foundation Inc.* v. *Riddell,* 244 F.2d 803, 805 (9th Cir. 1957) (supporting the view adopted by the Court of Appeals that inferences drawn from undisputed facts are to be treated like any other findings of fact).

In *United States* v. *United States Gypsum Co.,* 333 U.S. 364, (1944), this Court suggested distinctions between the applications of Rule 52(a) to findings based on a resolution of disputed evidence and those based on documents or undisputed facts and pointed out the difference in the weight to be accorded the findings of a trial judge as compared to those of a jury. In *Commissioner of Internal Revenue* v. *Duberstein,* 363 U.S. 278 (1960), the Court held that primary inferences drawn from undisputed facts are subject to the "clearly erroneous" test of Rule 52(a). The issue there was whether a transfer of property was a "gift" or a payment for services.

While *Duberstein* dispelled the contention that a reviewing court may ignore the inferences drawn by a trial judge from undisputed facts, it has not resolved the confusion with respect to the proper application of Rule 52(a) in many circumstances. Thus, while *U.S. Gypsum* was cited with approval in *Duberstein,* some circuits seem to hold that *Duberstein* has eliminated any distinction between findings based on the resolution of disputed testi-

mony and inferences drawn from undisputed facts despite the express language of Rule 52(a) which requires consideration of the extent to which the credibility of witnesses is involved. Such is the import of the holding here. Other circuits, however, have continued to recognize the distinction between various types of inferences. *Armour and Company* v. *Celic,* 294 F.2d 432, 437 (2nd Cir. 1961). Whether *Duberstein* is intended to hold that Rule 52(a) applies with as much force to inferences drawn from undisputed evidence as to issues of credibility is unresolved. Compare *Maryland* v. *U.S.,* 329 F.2d 722, 723 (3rd Cir. 1964), *affirmed* 381 U.S. 41 (1965), with *Lundgren* v. *Freeman,* 307 F.2d 104, 113-15 (9th Cir. 1962).

The distinction drawn in *Armour & Company* between the weight to be afforded primary inferences as compared to secondary or derivative inferences is directly applicable to this case. Here, several of the trial court's crucial findings are secondary inferences derived from other inferences.

In addition the Court of Appeals confuses the standards of review applicable to the findings of a trial judge with those applicable to the findings of a jury. In defining the scope of its review of the trial court's inferences, the majority opinion states (App. C, 89):

> "Our function is to ascertain, after considering the record in its entirety, whether the inferences drawn by the trial judge have a sufficient evidentiary basis so that it can be said they are reasonable, that is, *could* have been arrived at by logical deduction." (Emphasis supplied.)

The rule stated is that which applies to jury verdicts and is wholly inapplicable to the review of findings of a trial judge under Rule 52(a). *Orvis* v. *Higgins,* 180 F.2d

537 at 539 (2nd Cir. 1950); cf. *United States* v. *United States Gypsum, supra,* at 395.

As the limits of civil liability are extended, so with increasing frequency crucial issues are determined by inference rather than direct evidence. The administration of justice requires that the standards of appellate review of primary and derivative inferences be clarified.

CONCLUSION

The decision of the Court of Appeals for the Seventh Circuit extends the civil liability of corporations under Section 10(b) and Rule 10b-5 significantly beyond any previous case. It will make corporations and their investors virtually insurers against the misconduct of outsiders dealing in the secondary market in the company's securities. That decision, with its far reaching consequences, should be reviewed by this Court.

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